

COST OF SALES AND INVENTORIES

Several thin, white, parallel lines of varying lengths and angles are positioned on the right side of the slide, extending from the top right towards the bottom left, creating a sense of motion or a modern design element.

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Objective

The objective of IAS 2, *Inventories* is to prescribe the accounting treatment for inventories. In particular it provides guidance on the **determination of cost** and its subsequent recognition as an expense, including any write-down to **net realisable value**.

- ▮ Inventories can include:
 - **goods purchased and held for resale**
 - **finished goods**
 - **work in progress** (part completed goods)
 - **raw materials** awaiting use

COST OF SALES CALCULATION

□ Opening inventory	X	
□ Purchases	X	
□ Delivery inwards	X	
□ Closing inventory		(X)
□ Cost of sales		X

- Cost of sales is deducted from revenue (sales) to arrive at gross profit.
- When a large amount of purchased or manufactured items are stolen or lost, we must remove them from the cost of sales and treat them as an administrative expense, so as not to distort gross profit.
- Inventory, both opening and closing, features in the statement of profit or loss.

UNSOLD GOODS AT THE END OF A REPORTING PERIOD

- ▮ Goods might be unsold at the end of a reporting period and so still be **held in inventory**. Under the **accruals concept**, the cost of these goods should not be included in cost of sales as they have not contributed to revenue generation. Instead, the goods should be carried forward and matched against revenue in subsequent periods when they are sold.

DELIVERY COSTS

- ▢ Delivery costs refer to all **costs of transporting purchased goods** from the supplier to the customer. One party has to pay for these delivery costs: sometimes the supplier pays (in which case the customer has no costs to record) and sometimes the customer pays.
- ▢ When the supplier pays, the cost to the supplier is known as **delivery outwards** as the goods are going **out** of the business. When the customer pays, the cost to the customer is known as **delivery inwards** as the goods are coming **into** the business.
- The **cost of delivery outwards** is a distribution cost deducted from gross profit in the **statement of profit or loss**.
- The **cost of delivery inwards** is added to the **cost of purchases** and is therefore included in the calculation of cost of sales and gross profit.

SERVICE ORGANISATION-NEW

- **Direct labour costs** – this is the cost of any labour services directly related to the service provided. If, for example, a graphic design company has been commissioned to create new branding for a business's social media pages, the labour cost of the designer would be included, but the labour cost of the payroll manager of the graphic design company would not be included.
- **Sales commission** – if a business pays its employees a commission or bonus related to securing work, the cost of the commission paid should be included in cost of sales.
- **Materials used** – some service organisations will have some materials costs despite being service providers. For example, the graphic design company referenced above might incur printing costs in producing hard copies of the new branding or logos for presentation to the client.

INVENTORY WRITTEN OFF OR WRITTEN DOWN

- A business might be unable to sell all the goods purchased, because before they can be sold they might:
 - be lost or stolen
 - be damaged and become worthless
 - become obsolete or out of fashion; these might be thrown away, or sold off at a low price
- When goods are lost, stolen or thrown away as worthless, the business will make a loss on those goods because their 'sales value' will be nil.
- Similarly, when goods lose value because they have become **obsolete** or out of fashion and are sold off at a low price, the business will **make a loss** if their **net realisable value** is less than cost. If, at the end of a reporting period, a business still has goods in inventory which are either worthless or worth less than their original cost, the value of the inventories should be **written down** to:
 - **nothing**, if they are worthless; or
 - their **net realisable value** if this is less than their original cost.
- The cost of inventory written off or written down does not usually cause any problems in calculating the gross profit of a business, because the cost of sales already includes the cost of inventories written off or written down, as the following example shows.

INVENTORY DESTROYED OR STOLEN AND SUBJECT TO AN INSURANCE CLAIM

- Where a **material** amount of inventory has been stolen or destroyed, including its cost in gross profit will give a very distorted idea of the business's basic profitability:
 - Purchases will include the cost of goods that could not be sold, so the accrual principle is broken, yet they are not in closing inventory either, so it will look as if the business's gross margin on sales has fallen catastrophically.
 - There may be an amount of income as a result of an insurance claim, which cannot be included in cost of sales under the 'no offsetting' principle.
- These problems are overcome by taking the cost of goods stolen or destroyed **out of purchases** and including it under **administrative expenses**. An insurance claim is treated as **other income** in calculating net profit; if it has not yet been received in the form of **cash** it is disclosed as '**other receivables**' on the statement of financial position.

- **precise count** of inventories held at any one time
 - **Value** the inventories
 - **double entry bookkeeping** for inventories
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- Three parallel white diagonal lines in the bottom right corner of the slide.

▮ As inventory is a statement of financial position balance, closing inventory at the end of one period becomes opening inventory at the start of the next period. Opening inventory needs to be transferred from the inventory account to the cost of sales account (as it will be sold in the period) using the following journal:

▮ DEBIT Cost of sales X
▮ CREDIT Current assets – inventory X

▮ Purchases of inventories are transferred to a cost of sales ledger account via the following double entry:

▮ DEBIT Cost of sales X
▮ CREDIT Purchases account X
▮

▮ The opening inventories and the purchases represent the total amount of inventory that a business can sell in a period. The inventory account is only used at the end of a reporting period, when the business counts and values closing inventory, during the inventory count. Once an inventory count has been carried out and the business has a value for its closing inventory, the double entry is:

▮ DEBIT Current assets – inventory X
▮ CREDIT Cost of sales X

▮ The closing inventory reduces cost of sales (as it represents amounts that have not been sold in the period). The debit balance on the closing inventory account represents a current asset in the statement of financial position.

▮ The balance on the cost of sales ledger account should then be transferred to the profit and loss ledger account as a component of the profit calculation at the end of the period.

▮ DEBIT Profit and loss ledger account X
▮ CREDIT Cost of sales X

ACCOUNTING

ADJUSTING THE INITIAL TRIAL BALANCE

- • The closing inventory is often accounted for after the initial trial balance has been prepared.
- • A journal entry is required to adjust the initial trial balance to transfer opening inventories and purchases to cost of sales and record closing inventory.
- • A new cost of sales line is added to the trial balance as a result of the journal entries posted.
 - The approach is as follows:
 - Calculate the value of closing inventories (see below).
 - Prepare the year-end journals for opening inventories, purchases and closing inventories (see above) and enter the journals as adjustment to the initial TB.

COUNTING INVENTORIES

- ▮ In very small businesses, when a business holds easily counted and relatively small amounts of inventory, quantities of inventories held at the date of the statement of financial position can be determined by physically counting them in an inventory count.
- ▮ It is more likely, however, that a business will hold considerable quantities of varied inventory and will use its computerised accounting system to maintain continuous inventory records. This means that the accounting system keeps a record for each line of inventory item, showing purchases and issues from the stores, and a running total. A few inventory line items are counted each day to make sure the records are correct – this is called a ‘continuous’ count because it is spread out over the reporting period rather than completed in one count at a designated time.
- ▮ Once the quantity of inventories is determined then a policy is required for valuing the inventory.

VALUING INVENTORIES

1. Basic valuation: lower of cost and NRV

- ▢ Inventory is normally valued at its **historical cost** (the cost at which the inventory was originally bought).
- ▢ The only time when (historical) cost is not used is when cost needs to be **reduced to net realisable value** (the expected selling price, less any costs still to be incurred in getting the inventory ready for sale and in making the sale). **In accordance with IAS 2, inventory should be valued at the lower of cost and net realisable value.**

1. Applying the lower of cost and NRV

- ▢ If a business has many inventory items on hand the comparison of cost and NRV should be carried out for each item separately. It is not sufficient to compare the total cost of all inventory items with their total NRV, unless the items are interchangeable such as nuts or bolts.

▢ Determining the cost of inventory

▢ Inventories may be:

- ▢ • raw materials or components bought from suppliers
- ▢ • finished goods which have been made by the business but not yet sold
- ▢ • part completed items
- ▢ • goods purchased and held for resale

1.What is included in the total cost of an item of inventory?

- The total cost of an item of inventory includes all costs incurred in **bringing the item to its present location and condition**. This consists of:
 - the purchase cost of **raw materials**
 - **delivery inwards**
 - import taxes and duties
 - conversion costs

- ▮ **FIFO (first in, first out):** Items are assumed to be used in the order in which they are received from suppliers, so oldest items are issued first. Inventory remaining is therefore the newer items and cost is measured as such.
- ▮ **LIFO (last in, first out):** Items issued are assumed to be part of the most recent delivery, while oldest consignments are assumed to remain in the stores. **LIFO is not allowed under IFRS Standards** and it not considered further in *Accounting*.
- ▮ **AVCO (average cost):** As purchase prices can change with each new consignment received, the average value of an item is constantly changing. Each item at any moment is assumed to have been purchased at the average price of all the items together, so inventory remaining is therefore valued at the most recent average price.

VALUATION

1.Inventory valuations and profit

- FIFO and AVCO each produced different costs, both of closing inventories and also of materials issues. Since raw material costs affect the cost of production, and the cost of production works through eventually into the cost of sales, it follows that **different methods of inventory valuation will provide different profit figures.**

IMPACT ON PROFITS

- • Mark-up is calculated on cost.
- • Margin is calculated on sales.
- • Margin and mark-up can help us to establish the cost of an item of inventory.

USING MARK-UP/MARGIN PERCENTAGES TO ESTABLISH COST

□ If an owner takes items of inventory from the business as drawings, we do not need to adjust opening or closing inventory at all. Instead, we reduce the cost of sales with the cost of items withdrawn.

□ CU CU

□ DEBIT Drawings X

□ CREDIT Cost of sales X

INVENTORY DRAWINGS